America, Australia, Asia and the World Economy

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Thank you for the invitation to speak in New York.

New York City remains one of the world's dominant financial centres, on any metric. Its stock exchange is by far the largest in the world in terms of market capitalisation. The US corporate debt market similarly eclipses that of other countries and the city is home to some of the world's largest financial institutions. Likewise, the United States remains the world's largest national economy by a substantial margin.

But the world is changing, and quite quickly. The rise of China (and, very likely, India) is a transformative event for the global economy. Unless something pretty major goes wrong, we are likely to see much more of this trend for quite a long time yet.

As recently as 1990, the United States accounted for a quarter of the world economy. The European Union was just a little over a quarter. Japan, east Asia and India combined made up roughly another quarter; Japan on its own was about a tenth of global GDP. (Australia was then, and still is, just over 1 per cent of global GDP.)

In 2010, the US share was about 20 per cent of world GDP, about the same as the European Union. By then, Asia was making up just under a third of the total. China alone had raised its share of global GDP from less than 4 per cent in 1990 to over 13 per cent – quite a change in the space of 20 years. India's share, which had been the same as China's in 1990, had been little changed until about 2004. It has started to increase more noticeably since then, though it remains well below China's at the moment. But given that the demographics for India are more favourable than those for China, we could expect that in another 20 years India's prominence will have grown a great deal – assuming that country continues the process of reform that has helped it to generate impressive growth over recent years.

These figures are all based on the IMF's Purchasing Power Parity estimates for countries' respective GDPs. Some might find them a bit abstract – if you doubt that, try explaining purchasing power parity to your mother. But we can appeal to various other 'real' indicators to chart the rise of China in particular. The number of people in paid employment in China was 780 million as of 2009. The increase since 1990 was about 130 million, which is nearly the total number of employed workers in the United States (and 11 times the total number currently employed in Australia).

In that year of 1990, China produced just over 50 million tonnes of steel products. By 2010, China was producing more than that volume of steel products each month, and accounted for nearly half of global crude steel production. Virtually all of this steel is consumed within China, to build new cities and transport infrastructure. Currently, steel consumption in China is nine times higher than that of the United States. Electricity generation has tripled in China over the past decade, overtaking the European Union in 2008 to become the world's second biggest generator of electricity after the United States. Of course, per capita usage rates of electricity are still much lower in China but they will rise with incomes. In 1999, just over 23 000 Chinese postgraduate students were studying abroad. A decade later, there were 230 000.

All of these metrics tell a similar story: the rise in the importance of the Chinese economy is extraordinary. Other countries in the Asian region have also shown solid rates of growth over this period, but the size and pace of change in the Chinese economy stands out.

There are few countries that have noticed this more in their trading patterns than Australia. Our trade patterns have been strongly oriented towards Asia since the emergence of the Japanese trade relationship in the 1960s. But this has taken a further step up in recent years, with the share of merchandise exports going to the Asian region rising from a little over 50 per cent as recently as 2003 to over 70 per cent in 2010.[1] A similar trend has occurred in imports. China alone has risen from 6 per cent of exports a decade ago to 25 per cent today. The rise in Australia's terms of trade – about which I will *not* give yet another sermon today – is part of this same picture.

But it is of course not only Australia that has seen this shift in trade patterns. In fact, many countries are seeing a significant expansion in two-way trade with China and there are a number for which China is now the most important partner. Among that group is not only Australia, but also Japan and Korea. Clearly trade integration has been happening quickly in the Asia–Pacific region.

These forces are also being felt further afield. The US economy has seen a much increased trade engagement with China. The share of US imports coming from China has increased from about 3 per cent in 1990 to 19 per cent today. That is a very large increase, though it appears to offset a decline in the shares coming from Japan and other east Asian countries: imports from Asia as a whole make up about the same share of US imports today – about a third – as they did 20 years ago. Probably what is happening here is that China has displaced other Asian countries to some extent as a source of finished products, including by becoming the final point of assembly for many manufactured items constructed from components sourced all over Asia.

Even more interesting is the fact that the United States sells a higher share of its exports to China than to any other single nation apart from Canada and Mexico, its two North American Free Trade Agreement partners.

All these trends will surely continue, for the process of integrating China and India into the global economy has a good way to run yet. The Chinese Government is seeking growth of 7 per cent per annum over the coming five years. That would be a lower outcome than we have seen in the past five years, but is still very strong by the standards of the advanced countries. Growth at that sort of pace, on average, would see China's weight in global GDP exceed that of the euro area within five years and approach that of the United States within a decade.

Of course, the future will not be that deterministic. The Chinese economy will have cycles; it will not trace out a path of steady, uninterrupted expansion. China could not expect to be immune from various other afflictions experienced by all countries that can occasionally impede economic growth. But by any reckoning, the emergence of China is a huge historical event. And then there is India.

So the world of production and consumption is changing.

But it must also follow that the world of finance is changing as well. As incomes rise so there is an accumulation of physical capital (which accommodates further increases in labour productivity and incomes) funded by saving out of current income. Moreover, the scale, scope and sophistication of financial activity increases, which typically sees the size of gross financial claims rise faster than income.

1 These and subsequent trade figures refer to merchandise exports.

The fact that Asian countries have traditionally seen quite high rates of private saving accentuates this trend. China's saving rate, at about 55 per cent of GDP, is one of the highest recorded and because China has become a large economy, the extent of that annual flow of saving is now globally very significant. In absolute terms, according to the available national income statistics, China is in fact now the world's largest saver. Its gross national saving, at an estimated US$3.2 trillion, exceeded that of both the United States and the euro area in 2010.[2] Its gross investment is also the world's largest – at an estimated US$2.9 trillion in 2010. The gap between these two figures – around US$300 billion – is of course China's current account position. That is the extent to which China, in net terms, exports capital to the rest of the world.

As you might expect, to deal with this large volume of saving China has some large banks. As measured by total assets, 12 of the world's 100 largest banks are Chinese. This is a higher number than for any other single country, including the United States. Between 2005 and the start of this year, the Shanghai and Shenzhen stock exchanges grew by over 800 per cent. As measured by the market capitalisation of listed domestic companies, the Shanghai stock exchange is still far smaller than the New York stock exchange, but it is now more than two-thirds the size of the London and Tokyo stock exchanges. In terms of turnover, the annual value of share trading on the Shanghai stock exchange in 2009 surpassed that of each of the London and Tokyo exchanges.[3]

Asian bond markets, and particularly those in China, have also grown in size. Five years ago, total domestic debt securities outstanding in China were less than half of those outstanding in countries such as France, Germany and Italy; today these markets are roughly all comparable in size.[4]

So it is not just the centre of gravity of economic activity that is shifting to Asia – the weight of financial assets is also shifting. Now this is a slower process since the stock of wealth is a result of a long accretion over time and economies that rapidly become large in production terms may have a smaller stock of wealth than countries that have been similarly large for a long time – such as Europe and the United States. So at this point the advanced industrial countries still account for the lion's share of global wealth.

Nonetheless, things are moving quickly. Within the remainder of the careers of many of us here today, we will very likely see a pretty substantial change in relative positions. It is interesting to contemplate how that world might differ from the one to which we have been accustomed.

Every morning, Australian financial market participants wake up to the closing moments of the New York trading day. The rest of the Asian region wakes up shortly thereafter. Despite the rapid increases in size of the Asian markets, most of the time it is changes in US or European markets that set the tone for the Asian trading day.

Every so often, though, an event in Asia prompts global market responses. Surely this will happen more often in the future. As the Asian region becomes more integrated economically, with an ever larger Chinese and Indian economic mass at the core, and as the accretion of Asian financial wealth assumes increasing global significance, Asia is likely more often to be a source of 'shocks' for the global economy and financial system. I am not suggesting that Wall Street will dance exclusively to Shanghai's tune. The US economy and financial system will remain very large and internationally important for the foreseeable future.

The point is that there will be several potential sources of music emanating from various centres around the world, to which markets everywhere will respond to some extent. The United States will certainly be one, and so will Europe (not always an

2 These data are compiled from IMF Article IV and *World Economic Outlook* reports.

3 Annual value of electronic order book trades.

4 Total outstanding debt securities issued onshore in local currency, measured in US dollars.

enjoyable tune of late). We will all need to attune our ear to Asia's rhythms as well.

Sometimes those differing tunes will clash – as they do at present. At the moment we see a US recovery that is gaining some traction after a lengthy period of weakness, a subdued experience in Europe overall with intraregional differences probably at their most extreme since the euro commenced, while China and India are seeking to slow their expansions in the face of clear evidence of rising inflation. US banks are well ahead of their European counterparts in cleaning up their problems, to the extent that the government capital injections of two years ago are being repaid, while markets are still waiting for more complete information about the state of balance sheets in Europe and worrying about the feedback to public sector finances. Asia's banks, meanwhile, did not have a solvency crisis and have been able to perform their task of supporting growth. If anything, their problems are more likely to be those of exuberance. More attention is being paid to the US fiscal position – and that will probably increase further. In Asia, public finances are generally strong except in Japan.

These differences were bound to increase the focus on policy differences between regions, and exchange rate systems in particular. It is not surprising that we are returning to discussion of the 'global imbalances', since many of the underlying factors behind them have not gone away. Renewed efforts to find a framework for talking about these issues are now under way.

As others have said, a prerequisite for a solution is a shared understanding of the problems within an agreed intellectual framework. But finding that combination is not proving easy. The dialogue needs to occur on multiple issues, to which countries bring different perspectives. Many of the countries of Asia come, for example, with a mindset in which the international monetary system is a device for stability, one of the foundations for strategies to grow economies and increase wealth. They see flows of capital, and fluctuations in exchange rates, as potentially disruptive to the real sectors of their economies. This is in many respects a traditional post-war perspective, when there was a US dollar standard, when the United States as an economic and financial power was unrivalled and all other economies and financial systems were truly small. But of course Asia is no longer small.

Countries like the United States or Australia, on the other hand, have a different frame of reference. They tend to see the international monetary system as a device for accommodating shocks and reflecting differences in economic circumstances. They see price movements and capital flows, generally, as helping resource allocation. European countries share that perspective as far as flows and exchange rates between the major regions of the world are concerned, but share Asian perspectives on the need for stability within their own region. There are good reasons, in logic and history, for all these perspectives. We need to understand them, and find an accommodation.

It does not help, in my judgment, that so much of the discussion takes place through a bilateral prism – particularly the US–China current account prism. Twenty years ago the prism was the US–Japan balance. The issues are multilateral, not bilateral. The US trade deficit was pretty widely spread for many years. It wasn't just with China. Over the past decade, the United States had a trade deficit with 13 of the 18 other countries in the G-20 (of the five surplus positions, the largest was with Australia). This bilateral focus can be quite troubling, and not only because it risks oversimplifying problems and therefore lessening the likelihood of solutions. It can be troubling for a host of small countries, which worry about the potential for more widespread effects of solutions that may be attempted. This is why it is so important that the problems be considered, and resolved, in a multilateral setting. Hence the importance of the international financial institutions, and of fora like the G-20, in providing the table around which these discussions should take place.

That of course means that the legitimacy of those institutions, in the eyes of all their stakeholders, is key. Good progress has been made in improving the governance of bodies such as the IMF and no doubt more will be done in this area over the years ahead. The G-20, a body with a broader constituency than the G7, has taken a more prominent role. This is all good, but will need to be accompanied by ongoing efforts to reach a shared vision of the role of the institutions and the system they are supposed to watch over and protect. If we are all still not talking the same language about the role of the system or the institutions, then we will not collectively get very far.

So much work needs to be done yet. America – still the world's dominant single economy and financial power, albeit not as dominant as it was – is critical to reaching the necessary framework. But so too is Asia – a fast-growing, high-saving region with increasing financial resources, a much increased part of the global economy and financial system, and with, therefore, commensurately increased responsibilities. Australia – a small but outward-looking country with very substantial ties to both the United States and Asia – has more than a passing interest in the progress of this very difficult, but very important, discussion.